Testimony of

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PPPs: Protecting the Public Interest

Good morning, Mr. Chairman, Ranking Member Duncan and Members of the Committee. My name is Alistair Sawers and I hold the title of director at RBC Capital Markets where I head the Western region of the Infrastructure and Project Finance Group. It is my pleasure to discuss with you today the experience of other jurisdictions, particularly in Europe, in protecting the public interest while carrying out public-private partnership (PPP) programs.

In the last 13 years I have had the privilege of advising either the Public or Private sectors on over 40 PPP procurements in 12 different countries including the UK, Canada, Spain, Portugal, Sweden, Chile and the Russian Federation as well as in 5 different States in the US.

My remarks today will be focused on public policy issues that arise in these transactions and the approaches to resolving these issues adopted in other jurisdictions. My remarks will focus primarily on use of PPPs to provide the design, construction, financing, and operation and maintenance of new facilities.

Defining the concepts

Defining Public Private Partnerships

- Public Private Partnership ("PPP") relationships are very different from privatization, in which the market and price mechanism defines the service provided. The private sector has always been involved in the building and maintenance of public infrastructure. PPP ensures that contractors are bound into long-term maintenance or operating contracts and take responsibility for the quality of the work they do. With PPP, the public sector defines what is required to meet public needs and remains the client throughout the life of the contract. The public sector also ensures, by contract, delivery of the outputs it sets and has rights under those contracts to change the output required from time to time. In a PPP, the government role changes from that of directing and managing infrastructure to one of oversight and maintenance of quality service outcomes.
- The term PPP covers a broad spectrum of Private involvement in the procurement of Infrastructure which is summarized for reference in the table below. It does highlight that the default method of procurement in the majority of international jurisdictions is Design Build. As a result most international comparisons between PPPs and conventional procurement are comparisons with Design Build.

Procurement Option	Design & Construction	Operations & Maintenance	Tolling Operations	Construction Finance	Repayment	Examples
Government Procurement	x				Milestone payments	Design & Build (D&B) most countries
Construction Finance	x			x	Lump sum on completion	German A Model
Build Transfer Lease	x			x	Lease payments over time	Korean BTL, and UK Design Build Finance Transfer (DBFT)
Concession without tolling	x	x		x	Availability payments	UK & Hungarian DBFO, Canadian P3s
Concession with shadow toll	x	x		x	Shadow toll payments	Early UK DBFO, Portuguese SCUTs
Concession with toll operation	x	x	x	x	Toll revenue	Croatia, Spain, Chile, USA Toll Roads, German F Model
Concession collecting tolls	x	x	x	x	Availability payments	Some Norwegian PPPs

- Similarly more of the International PPPs in the Highway and Transit sectors are focused on new construction projects, which are also known as Greenfield projects rather than refurbishment or enhancement projects, which are also known as Brownfield projects. Currently in the US the focus has been more on Brownfield projects, though again these vary from: the mainly Operations & Maintenance focused such as Chicago Skyway; to the Refurbishment focused such as the Missouri Bridge Replacement PPP; to the enhancement focused such as the I495 Managed Lanes/HOT Lanes. Each has different risks and requires a slightly different approach.
- These warnings aside there is much to be learnt from the international experience in PPPs, especially as many of the engineering companies and investors in the US PPP market have international experience. Examples include Fluor, Bechtel, Kiewit, Granite, KBR (Halliburton), Aecom, John Hancock and GE Capital as well as the well publicized Macquarie Infrastructure Fund and Cintra.

Issues of Public Interest Regarding PPPs

Benefit to the User

- The primary focus should be maximizing the benefits to the user given the finite sources of revenue to pay for them. These breakdown into:
    - improving the user benefits in terms of reduced journey times and variability in those times and improved quality of service;
    - reducing the whole-life cost of the service (highway/bridge/streetcar etc) either by increased efficiency or by cost reductions; and
    - maximizing alternative revenue sources or reducing revenue volatility to maximize the amount of funds which it can be used to raise.
- Improving user benefits is not just a matter of delivering a new project. It is also a matter of addressing policy objectives regarding issues such as congestion, corridor management, safety and land development. In a PPP the public sector loses the ability to modify project once it is defined in the concession contract, in return for transferring cost risks. As a result, the outputs of the PPP have to be carefully defined in the concession and the incentives have to be carefully structured. In the case of the latter, Norway has procured PPP toll roads where it has chosen to retain the tolls and pay an availability payment with safety and performance deductions to match its policy objectives. In contrast, the second phase of the Manchester Transit PPP had a performance regime which was not detailed enough, so when traffic did not grow as expected the operator fell behind on station maintenance and cut other discretionary costs and the Public Sector had no remedy.
- In the UK which was one of the first countries to wholeheartedly embrace PPPs in its Private Finance Initiative (PFI), one of the key motivations for PPPs was to transfer risks away from the Public sector where the Private sector was best placed to manage them. The focus on maximizing efficiency by optimizing risk transfer required a move away from low bid procurement to a more negotiated concept which took into account the risks accepted. This was named "value for money" and the concept is used now in many jurisdictions both to compare a PPP procurement to a publicly funded one and to a lesser extent to compare PPP bids with different risk allocations.
- Another objective of international PPP procurement programs has been to allow innovation in terms of both efficiencies and improving revenues. Simple cases have included peak hour pricing for tolls, regular pricing indexation and addition of the proceeds of Transit oriented development. Here the concern is that the public sector or the user gets value for these innovations rather than just being upside for the private sector.

Political Issues

- A significant concern, even if a project is thought to be good value for money is that the expected risks do not occur and the private sector earns unexpectedly high returns. Politically this is one of the key issues, especially where tolls or transit fares have been the source of the revenue, even though the private sector may be able to argue it was taking a high risk and should be recompensed. Another source of high returns on UK projects has been the refinancing of PPP project debt which resulted in equity investors receiving large windfalls due to the large drop in interest rates between the late 1990s and 2002-4.

- PPPs have created significant Labor issues in Canada, UK and some other European countries despite generally creating more jobs, especially in the construction industry. The issue has been more about the less favorable terms of employment in the private sector and the immediate reduction in headcount. In the US the issue is complicated by the reduction in work for the public sector Designers in some states.
- A typical PPP Highway or Transit project which is funded by user fees will be a monopoly (though may have competing modes) so there will be concern that the right Toll or Fare increases could be abused before revenues started to fall. Unfortunately this is more an issue of public perception regardless of how increases are controlled by the Concession Contract.

PPP's Inherent Protections

Contractual

- Contractual process forces the public sector to either more closely define the project or to create output specifications for the service. Once set the nature of the contract makes the changes much more difficult which cuts down variations and claims so while construction is typically more expensive using the initial prices, the final price is cheaper than a pure (Design) Bid Build. Initial experience with PPP procurement in the UK was that a large amount of the benefit of PPP came from reductions in change orders which reduced cost and delay. This effect should be especially pronounced compared to pay-as-go style projects where there are long gaps between phases which make changes and abortive work much more common.
- With PPP projects the Public Sector has 3 layers of protection against failure to complete construction compared only the Surety Bond under a normal procurement. The first layer is the concession company requiring bonds from the contractor, the second is the equity which stands to lose all of its investment (and frequently includes the contractor) and the final layer is the debt which has the option to step-in to the contract and ensure performance to save its money (which is typically 80-90% of the deal). A study by the UK Treasury in 2003 detailed in the box to the right found that these protections resulted in 89% of projects being delivered on time. Previous research had shown that 70 per cent of non-PFI projects were delivered late and 73 per cent ran over budget.
- As the Debt has only one form of security – the PPP contract – it is incentivized to police contract and many of its incentives are aligned with the Public Sector. In order to give the debt a cushion to remedy any problems before a default can be triggered, the debt will typically require stronger versions of the performance terms in the concession contract

> Research conducted by the Government and others, particularly the National Audit Office (NAO), confirms the largely positive impact of PFI to date and highlights areas where there is scope for further improvements. Chapter 4 provides details of HM Treasury research of 61 PFI projects. The key findings were:
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> - 89 per cent of projects were delivered on time or early;
> - all PFI projects in the HM Treasury sample were delivered within public sector budgets. No PFI project was found where the unitary charge had changed following contract signature – other than where user requirements changed;
> - 77 per cent of public sector managers stated that their project was meeting their initial expectations; and
> - there is scope to reduce procurement times, although there is evidence that new initiatives to tackle this problem are having an impact.
>
> *PFI: meeting the investment challenge – UK's H M Treasury July 03*
>
> *Note: PFI was the former name if the UK's PPP program*

to be reflected in the PPP company's construction and operation contracts. Another frequently quoted example is the bankruptcy of the PPP construction firm, Jarvis in 2005. All of its deals were restructured at no cost to the public sector, and despite having 21 at various stages of construction, new contractors were brought in to complete all of the projects.

- The PPP contract fixes the revenue sources for the PPP company for 30-99 years. Within that the PPP company is incentivized, subject to the construction and performance requirements, to optimize its initial investment and design to minimize the combined cost of construction, operation and maintenance ("whole-life cost") of the project. Examples include more robust pavement design which requires fewer maintenance interventions or toll gantry designs which allow maintenance without lane closures.

Procurement process

- The competitive process to procure a PPP project allows competition on both price and on acceptance of risk. This gives significant protection for a public sector procurer against signing a deal which is bad value for money as the PPP company needs to bid higher than its competitors.

Market Pressure

- Like a full privatized entity a PPP company which takes Toll or Fare risk, even if it has some monopoly characteristics is already incentivized to provide a quality service and to avoid pricing users away. On projects such as managed/HOT lanes this dynamic and the free alternative can very effectively regulate the toll and quality levels. This was amply demonstrated on the Mexican Toll road concessions when the PPP company attempted large toll increases to recover losses due to currency depreciation and the traffic diverted to the much lower quality free alternative.

Additional Protections used in International Projects

Contractual

- The problem of excessive returns has been addressed by several mechanisms including: a revenue share which triggers at high levels of traffic or equity return; or by terminating the concession when the return reaches a pre-defined target level. In most cases however, toll or fare restrictions are the main focus. Also a large number of international projects use capped Availability/Performance Payments or Shadow Tolls which are paid by the public sector and are capped.
- In addition to being capped Availability Payments include with specific incentive payments to address the public sector's policy objectives. In Norway the Roads Directorate pays a bonus based on the safety record of the PPP highway, in British Columbia on the Sea to Sky Project the are additional payments for meeting First Nations employment targets and deductions for closing lanes which vary according to the impact on the traffic flow. The UK Government has implemented a Congestion Payment regime on their A1 Darrington to Dishforth PPP project which is based on maintaining the average traffic speed above target levels.

- As mentioned above the Refinancing PPP projects can lead to windfall returns and many International PPP contracts now include provisions to share in the benefit. TxDOT has also included such a provision in its programmatic term sheet for its CDA projects.
- The issue of Compensation for Competing Roads or Transit projects has not had quite the same profile it has had in the US. Obviously, it is not an issue for Availability Payment schemes but it is an issue for Shadow toll roads, where the public sector payment is based on traffic levels, but there it is possible to rebase the payment to reflect the lower traffic levels which automatically compensates the PPP company. In most other cases, the agreement has been compensation for a demonstrated impact within a very narrow corridor, rather than any kind of non-compete like the one that caused the problems on SR91 in California.
- An early objective of the UK's PFI program was to turn procurement away from asset provision to service provision so the UK PPPs focused on specifying the service output rather than the design or procedures to be used. For highways this meant using performance payments based on indicators such as surface quality, skid resistance and incident response times. These standards had the added benefit of not being dependent on a particular technology.
- Labor protections have been incorporated into PPP agreements. Several countries have legislation which specifically addresses the transfer of Public Sector workers to the Private Sector and provides protection for all or a portion of their benefits and these have been integrated into PPP agreements.

Procurement

- As mentioned above, several jurisdictions undertake a value for money analysis of their PPP concessions at various stages of the procurement to ensure that the PPP project delivers better value than the conventional methods of public procurement (in the UK called the Public Sector Comparator, in Canada called the Shadow bid). While the valuation of the risks transferred in not an exact process, these reports have also proved useful in demonstrating value (or not as the case may be) of the PPP project to stakeholders such as the users or the appropriate legislature.
- In some Availability Payment projects this analysis is formalized into an affordability number (or else it is just based on the capacity of the public sector to pay). This provides a cap on the potential bids and puts pressure on the private sector bidding for the project. In the case of the Sea to Sky Project in BC it was used in a tender that defined the payment and asked the bidders to maximize the improvements to the highway for that price.
- Many countries have set up public entities to promote sharing of best practice in PPPs. Generally, the public sector teams procuring these projects will only work on one or two projects but they face bidders who have worked on many more projects. As a result the public sector needs access to past experience and PPP legal and financial advisors – in some cases these are provided by the entity or it just helps in the selection of external advisors. Examples include Partnerships UK, Partnerships BC in Canada, Partnerships Victoria in Australia and the Chilean Ministry of Public Works PPP team. Other countries have set up national PPP procurement teams focused on particular industries. Some of these authorities are involved in efforts to standardize PPP contracts to reduce bid costs and reduce procurement times. However these efforts are more successful where the countries are sufficiently centralized to enforce the use of these terms

Conclusion

- While the key motivation to undertake PPP projects will continue to be to find alternative sources of finance in order to deliver a project much earlier than by conventional means of financing, which in itself provides a significant public benefit, more attention will have to be given to value of risks transferred to the private sector.
- It should be noted that many of these protections can increase the risks, costs and complexity of the PPP project driving down overall value.
- Thus, as with risk transfer it's a trade-off between protection and price, and that trade-off is different for different types of PPP transactions.